Privatization:
Challenges and Lessons Learned
Shaping Future USAID Strategy

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I. Introduction: Objective and Methodology

The purpose of this brief paper is to support the staff of USAID's Europe & Eurasia Bureau, Markets Transition (E&E/MT) office in defining future strategic parameters.

In the early stages of economic transition, given that in the centrally planned economies of Eastern Europe and the former Soviet Union virtually all economic activity and assets were under state control, the strategic importance of privatization was evident. However, after roughly a decade of privatization initiatives, donors and practitioners are now questioning to what degree the process has been completed, and whether and how privatization in the region continues to be a strategic priority for USAID.

This paper is based on information generated through interviews, primarily with USAID staff in Washington and selected Missions, as well as with representatives of the World Bank and other contractors. The paper also draws on a secondary literature review and CARANA's experience in the region. A list of interviewees, and a summary of the interview findings are presented in the Appendix. Serbia and Kosovo are not included in the analysis.

The first section of the paper briefly describes the objective and the methodology used for developing conclusions and strategies for USAID/E&E involvement in privatization. The second section profiles the privatization experience and donor role to date. This is not an assessment but rather an effort to summarize what has been done (and how), and what remains. The third section highlights the major drivers shaping the privatization process, as perceived by different "stakeholders," And describes their implications for the future direction of privatization. The final section of the paper outlines recommendations for moving beyond privatization as it has been implemented to date, taking into consideration the E&E bureau's strategic framework. This strategy incorporates the results of the brainstorming workshop conducted on October 3, 2000 at USAID[1] as well as comments on the draft of this report.

II. Profile of Privatization Experience in E&E

In order to help identify meaningful trends and patterns, this section segments the privatization experience by sector and method of privatization.

A. Status by Principal Sector

1. Industry and distribution

Industry and distribution includes entities involved in processing and manufacturing, storage, wholesaling and retailing, mining, construction, common carrier trucking, and selected services such as agricultural machinery repair. In most of the transition

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[1] At this workshop an initial draft of the paper and alternative scenarios for privatization were discussed with key players from the E&E and Global bureaus of USAID.

countries, responsibility for these entities was generally transferred to a central State Property Fund or Ministry of Privatization.

For most entities, the first step in privatization has involved "corporatization" or the establishment of "joint-stock companies" (JSCs). Since most "companies" belonged to larger, integrated structures that controlled all of the activity in a particular area, the first question has always been at what level to "segment" the larger organization and what to include in each JSC. In manufacturing, this has been relatively easier since each factory has tended to be a logical business unit, although even here, decisions have had to be made as to whether to include "social assets" (housing, kindergartens, sports clubs, etc.) on their balance sheets.

In the large distribution related structures, decisions have had to be made as to whether and to what degree to segment retail, wholesale, warehousing and other activities. For the most part, retail outlets have been segmented (and not corporatized). However, in a number of countries, much of the old, vertically and horizontally integrated structures has been retained in key areas such as grain/flour, fertilizers, and pharmaceuticals.

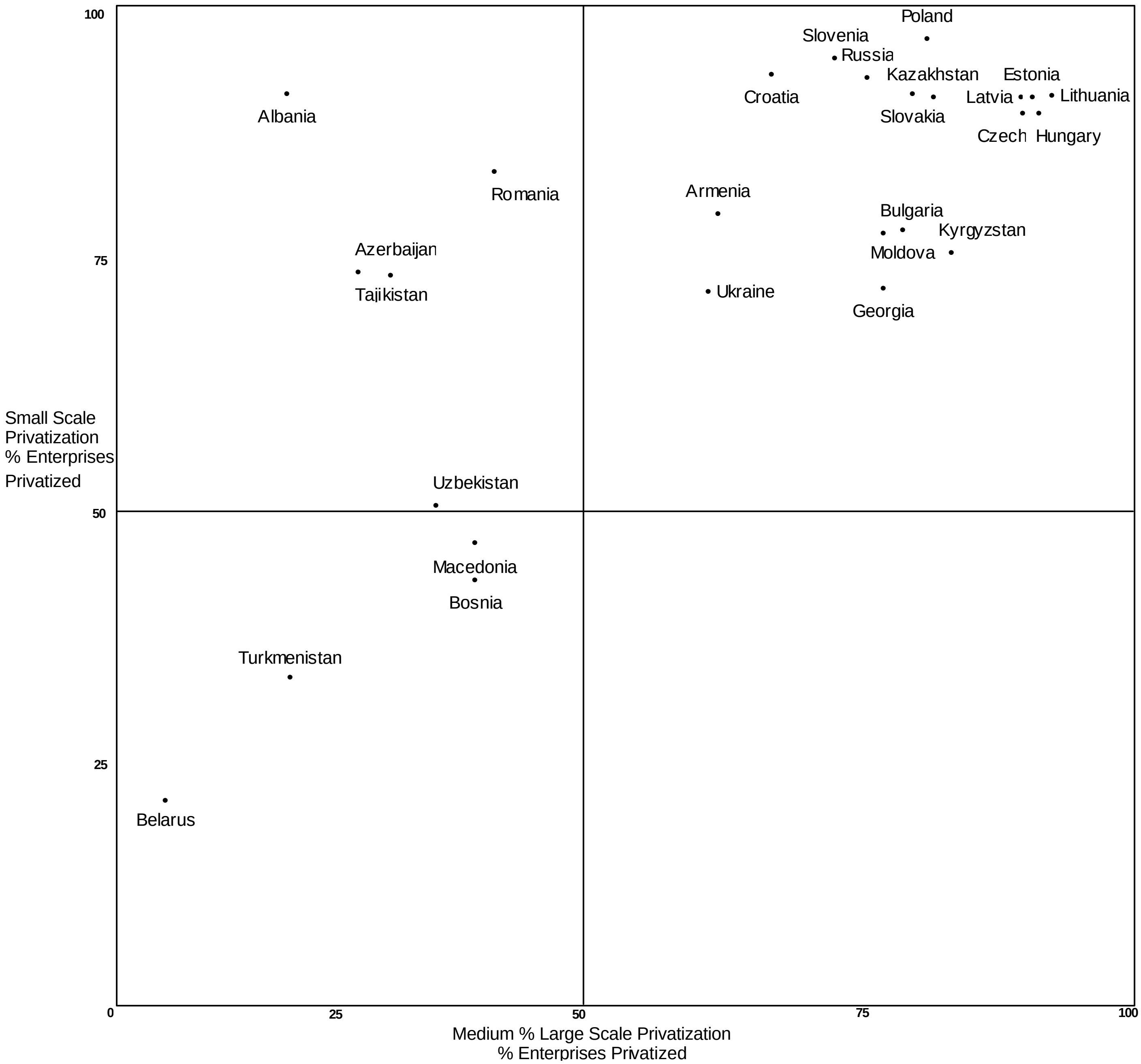
In most countries the corporatization process is virtually complete. The large number of assets in each country that were segmented and not corporatized (e.g. retail stores and services, trucks) have generally been sold through cash auctions, and referred to as small-scale privatization. In a few countries, mechanisms were introduced to allow worker collectives to acquire the entity where they work. As can be seen in Figure 1, the process of small-scale privatization is largely complete with the exception of Belarus and Turkmenistan, and to a lesser extent Bosnia and Uzbekistan. However, in a number of countries, local governments still own a significant amount of commercial real estate. In the absence of other sources of revenue, they often prefer to lease out these assets rather than sell them.

Figure 1 also summarizes progress in privatization of medium and large enterprises. In contrast to the sale of small non-corporatized assets, the sale of larger corporatized companies has proven to be much more complicated and taken a number of different paths. In the earliest efforts, in Hungary, Poland and Czechoslovakia, extensive work was done with the help of outside advisors to prepare individual companies for sale (or in Poland groups of companies in particular subsectors), especially to foreign investors. However, the time and resources required for each transaction, relative to the very large number of companies to be sold (and limited number of buyers), made it apparent that the privatization process would take forever and be prohibitively expensive. Countries began to look for ways to expedite the process for selling larger companies.[2] The principal approaches have included:

- *Voucher or "mass" privatization*—First used in Czechoslovakia and then Russia, variants of this approach have been widely applied throughout the region, notably in

[2] The term "mass" privatization would probably be most appropriately applied as being the rapid, systematic sale of large numbers of companies. However, it has come to be associated with one particular approach based on the distribution of vouchers to the mass of the population.

FIGURE 1: Privatization Status in Industrial & Distribution Sectors



Source: *EBRD, Transition Report 2000 &CARANA estimates*

Kazakhstan, Ukraine, Kyrgyzstan, Moldova, Romania, Bulgaria, Georgia, Armenia and now Bosnia. Vouchers distributed to the population (free or for a nominal price) can then be exchanged for shares in companies being privatized. Variants have included allowing citizens to participate directly, requiring participation through investment funds, or both options. In some countries, vouchers can be bought and sold, in others not. In most cases, only a percentage of the shares have been privatized this way, often no more than 20-30%. Another block of shares has usually been turned over to the workers, ostensibly to recognize their role as key "stakeholders", but also to reduce their likely opposition to privatization.[3] Government has usually retained a significant block of shares (typically between 10-30%), often leaving it as the largest single shareholder. These residual shares in government hands remain an important corporate governance and privatization issue in a number of countries.

A variant of mass privatization was applied in Poland with about 500 companies. Foreign/local financial consortia established funds with primary responsibility for a group of companies and minority participation in other firms. The population received shares in these "mutual funds" which were supposed to create value by restructuring the companies under their control.

- *Tender privatization* – Based on the Treuhand model in East Germany, a number of countries (Hungary and the Baltics are notable examples) have chosen to sell some or all of their medium-large companies in this sector through various types of tenders. Conditional tenders, which require bidders to address employment, investment, environmental and other conditions established by the seller, have been more common than unconditional tenders that are adjudicated on price alone. Buyers usually obtain a majority control of the company, although the government may retain residual shares. The government privatization agencies have usually managed to run tenders themselves, with assistance from advisors on how to structure the process.

- *Direct sales* – The largest "strategic" companies are largely sold to "strategic investors" through direct sales, usually organized by external advisors. In order to expedite the process, Romania and Bulgaria are examples of countries that assigned "pools" of companies to be sold by each investment bank.

As plotted in Figure 1, 18 out of 25 countries are in the upper right quadrant indicating that most of their enterprises have been privatized. In these countries, the remaining issues are the sale of selected "strategic" companies and the sale of residual state shares in medium and large scale companies. Five countries are in the upper left quadrant suggesting that they are lagging in the privatization of medium-large scale companies. Only three countries (Belarus, Turkmenistan and Bosnia) are lagging in both small-scale and medium-large scale privatization.

[3] The most extreme case was in Russia where workers/managers could opt to obtain over 50% of the shares. This has been widely criticized as having constrained restructuring. However, others argue that this was politically the only way to "buy" the tacit support of the powerful industrial elite and move forward in breaking up and privatizing over 18,000 large companies.

2. Land/agriculture

Privatization of agricultural land and farms has proceeded in two different directions in the transition countries. Countries with a tradition of small-scale agriculture (e.g. Georgia, Armenia, Albania, Romania, Bulgaria, Moldova) prior to World War II, have experienced "spontaneous" privatization in which families simply repossessed their farms with or without support and sanction by an organized privatization authority. In some countries in Eastern Europe, formal privatization programs have been burdened by complicated legal claims made by former owners.

The second general pattern has involved the very large collective farms, especially in Russia, Ukraine, and Kazakhstan. In these countries, where farms averaged between 10,000-100,000 hectares, the tendency has been to "corporatize" the farm and distribute shares to the workers and residents (including large numbers of pensioners). Individuals have usually had the option to exchange their shares for some land and equipment, but this option has been taken by a relatively small minority. There have also been selected efforts to "segment" the farms into smaller, more easily managed components.

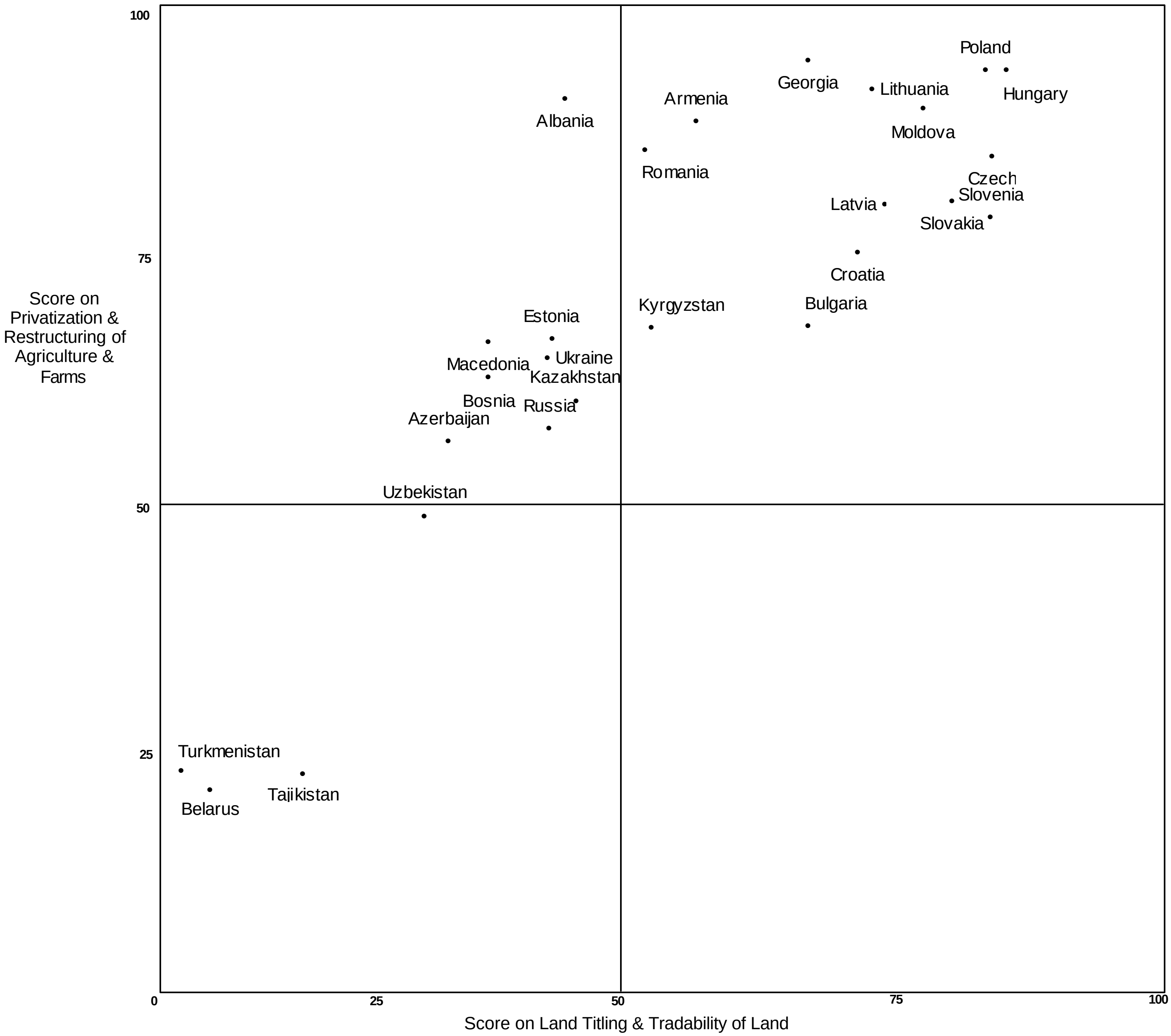
Most agriculture is nominally considered "private", but only in some countries do farmers hold clear title to the land and/or have a right to buy and sell.[4] Only a few countries in the former Soviet Union, notably Moldova and Georgia, have implemented systematic cadastral and titling programs.

Figure 2 plots the status of agricultural privatization and land titling by country. The vertical axis indicates the extent to which collective farms have been privatized (up to 50 points if they are converted into private companies) and restructured (up to 50 points to indicate the extent to which they have been broken up and/or reorganized). The horizontal axis provides an estimate of the extent of land titling and tradability of land.

The figure suggests that 14 countries (out of 26) are in the upper right quadrant, having made major progress in both directions. An additional 9 countries have made more progress in the privatization of farms than in land titling and development of a land market. Only three countries have made little progress in either direction.

[4] This excludes the "dachas" or plots which were always private, as well as much of the land in Poland which was never collectivized.

FIGURE 2: Privatization Status in Agriculture & Land



Source: *CARANA estimates*

3. Utilities

Privatization in the utilities sector, primarily involving telecommunications and energy, has focused on both the sale of assets as well as restructuring/liberalization aimed at promoting greater competition and improved service.

In telecommunications, in order to maximize sale proceeds, the first wave of privatizations often involve the sale of the PTT, to strategic investors, as an ongoing monopoly for fixed line service. These sales are frequently followed or paralleled by the sale of licenses for mobile services. Examples of countries that have designed or are in the process of implementing telecoms sales include Slovakia, Georgia, Bulgaria, and Armenia. More recently, some countries have been considering liberalization and competition as an integral part of the privatization strategy, preferring to emphasize the value of improved telecommunications to competitiveness and growth, over maximizing the one time benefit to the budget. In this latter approach, developing a regulatory capability takes on greater importance. Most countries are in some stage of liberalizing and privatizing their telecommunications sectors, although most still have a ways to go to complete the process.

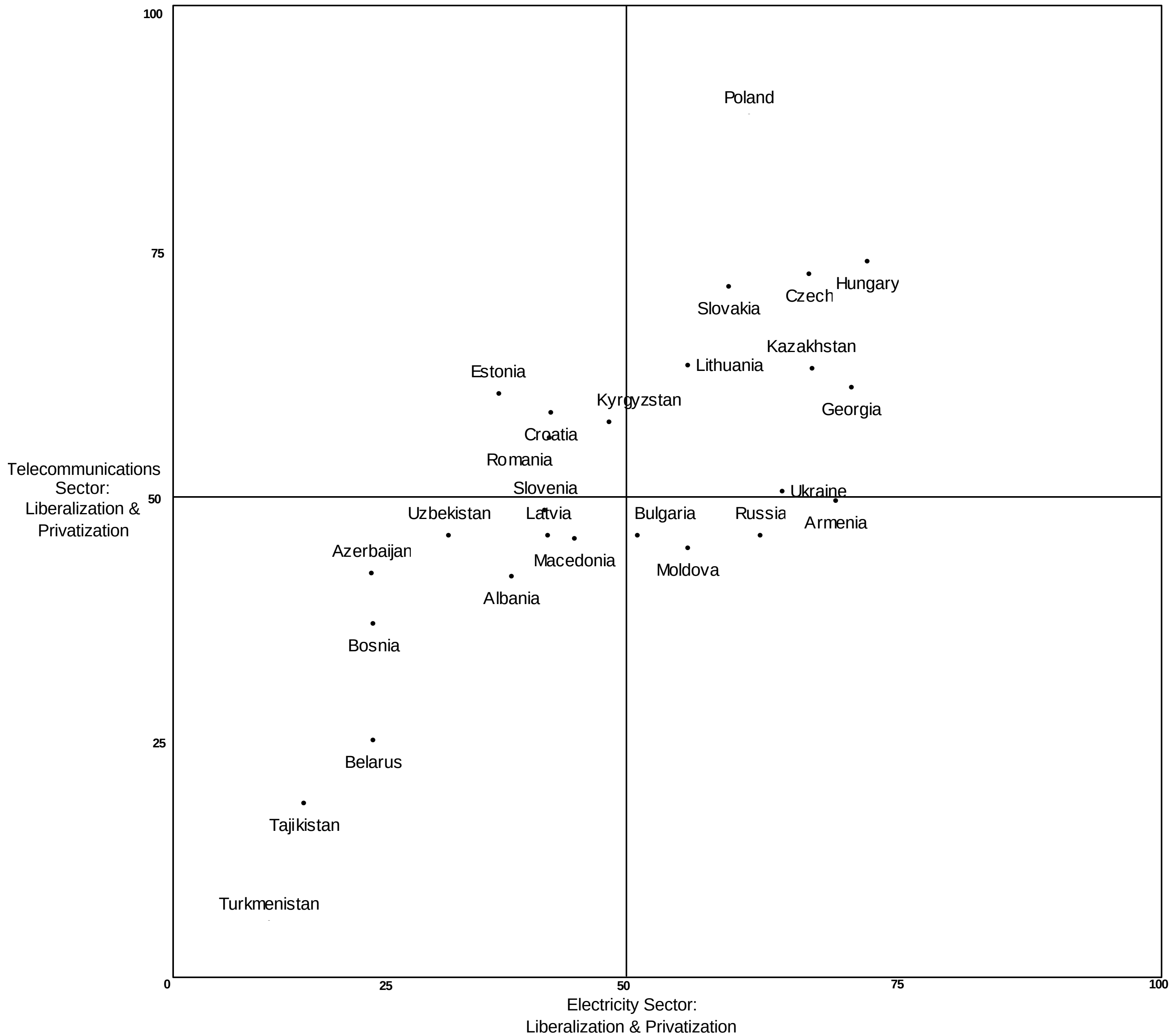
In electricity, the principal strategic question has been whether to introduce competition, and whether and how to segment generation, transmission and distribution. Countries have been taking different paths, although it seems that the general trend is towards fomenting greater competition.[5] Decisions on whether and how to privatize (through sale or management contract) have also varied greatly. Relatively few countries in this region have opted to promote BOOT schemes as a means of financing private investment in new capacity. As with telecommunications, countries emphasizing competition have had to establish a regulatory framework and institutional capacity.

Figure 3 provides an indication of where countries are in terms of privatization and liberalization in electricity and telecommunications. For each sector, up to 50 points are given for privatization of state companies. Up to 50 points are also awarded to reflect the level of competition, segmentation (e.g. of vertically integrated electricity companies) and regulatory support of a level playing field. The overall conclusion is that there is more still to be done in utility sectors than in the privatization of manufacturing and distribution companies, but much of the remaining work has more to do with competition issues than with transfer of ownership.

In these two sectors, only 8 of 26 countries are in the upper right hand quadrant, indicating significant privatization and liberalization of both telecoms and electricity. In general, there is more progress in telecommunications, and especially in the sale of the fixed line provider and licensing of wireless operators, which is why there are five additional countries in the upper left quadrant.

[5] Countries that aspire to EU membership must prepare for competition requirements.

FIGURE 3: Status of Privatization & Liberalization in Utility Sectors



Note: 100 score = full liberalization/competition and privatization. Equal weight is given to liberalization and privatization in assigning scores

Source: *CARANA estimates*

Nine countries are in the lower left quadrant indicating little progress with both telecommunications and electricity. Three countries, Moldova, Bulgaria and Russia are making more progress in the electricity sector than in telecommunications.

There have also been scattered experiments to privatize other infrastructure. For example, ports in Georgia and Russia, and airport management in Moldova. However, most infrastructure remains in state hands.

4. Financial sector

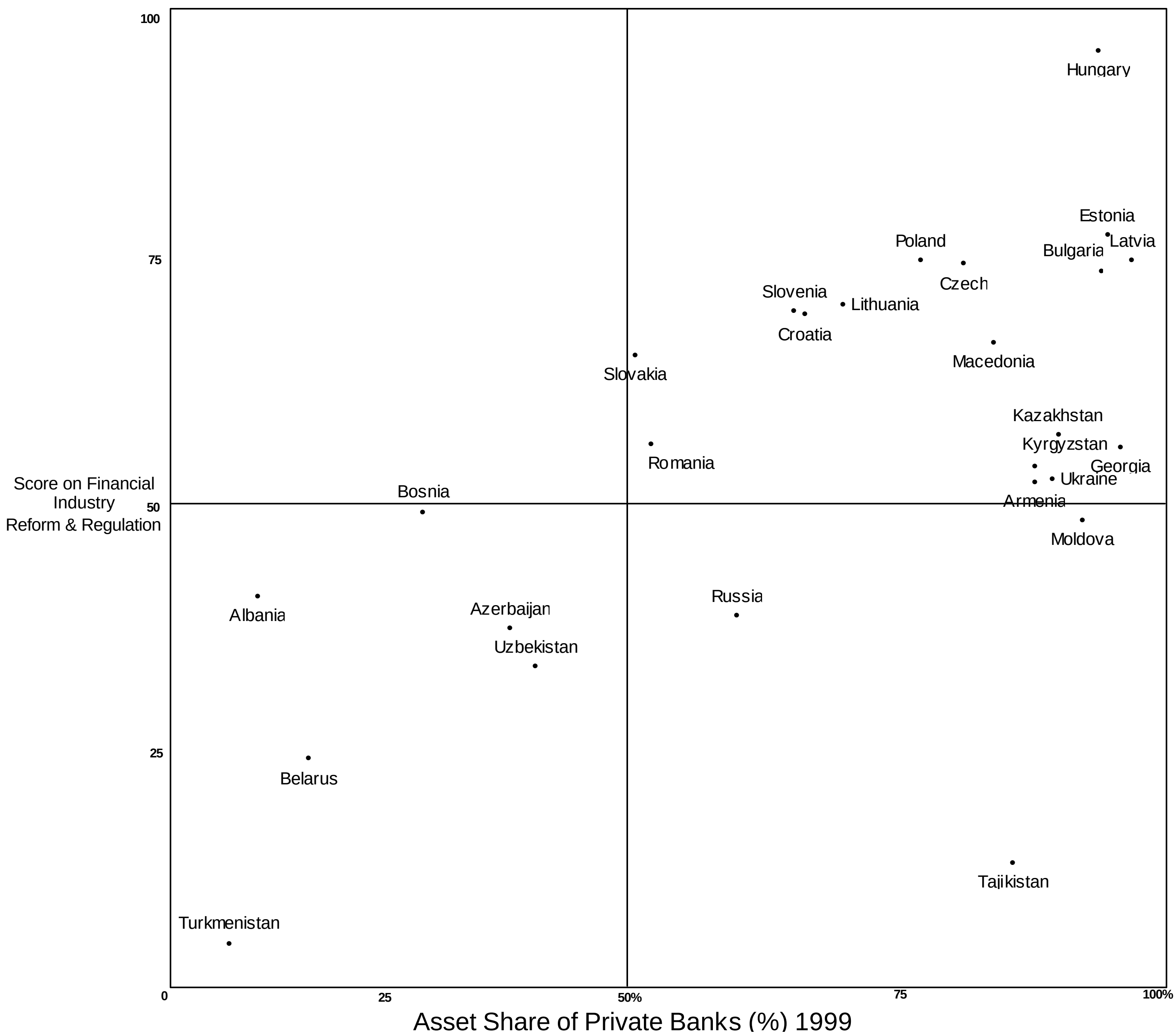
The financial sector has usually been treated separately from other companies during the privatization process. In most countries, the financial sector includes primarily banks and insurance companies, with each institution having had a specialized monopoly during the socialist times (e.g. savings, agriculture, trade banks and casualty insurance). Banks have been sold on a case-by-case basis, especially in central European countries such as Poland, Romania, Bulgaria and Czech Republic. The privatization of banks has been complicated by their poorly performing loan portfolio (especially to state companies), and in some cases by their direct and indirect involvement in the privatization process. Thus, for example, state owned Czech banks controlled some of the principal investment funds created during the privatization process. In Slovakia and Croatia, for example, it has been necessary to set up special agencies and/or asset disposition programs to help deal with the bad loans.

Relatively few insurance companies have been sold in the region, but this may reflect the underdeveloped level of the industry.

However, the principal force for “privatization” in the financial sector has been the establishment of new private banks (initially with minimal capital and regulatory requirements), and eventually the entry of foreign banks and insurance companies (both greenfield and through the purchase of state banks). In recent years, and especially following the financial crisis of 1998, there has been more emphasis on increasing capital requirements and strengthening the capacity of bank regulators.

Figure 4 graphically depicts the status of bank privatization and financial sector reform in the region. The horizontal axis measures the percent of assets held in private banks whereas the vertical axis reflects the level of overall financial sector reform as estimated by the EBRD and CARANA. The figure shows 17 of 26 countries in the upper right hand quadrant, which means high marks along both dimensions. Five countries are in the lower left quadrant.

FIGURE 4: Privatization & Regulatory Status in Financial Sector



Source: *EBRD, Transition Report 2000 & CARANA estimates*

5. Municipal services

The general trend towards decentralization of government has left significant assets in the hands of local governments. These differ by country, but tend to include water and sewage, garbage collection and disposal, urban transport, heating (and sometimes electricity), housing, kindergartens, and hospitals. With limited sources of revenue and management talent, local governments have been hard pressed to maintain these assets and provide adequate services. These difficulties have given rise to privatization initiatives involving the sale of assets, management contracts and/or new private service providers. For example, Poland has seen a number of cities privatize the management of water distribution. A number of cities in Ukraine have also been examining the restructuring and privatization of water and wastewater. Despite these initiatives, and with the exception of housing, most municipal services are still in local government hands.

6. Summary Status of Privatization

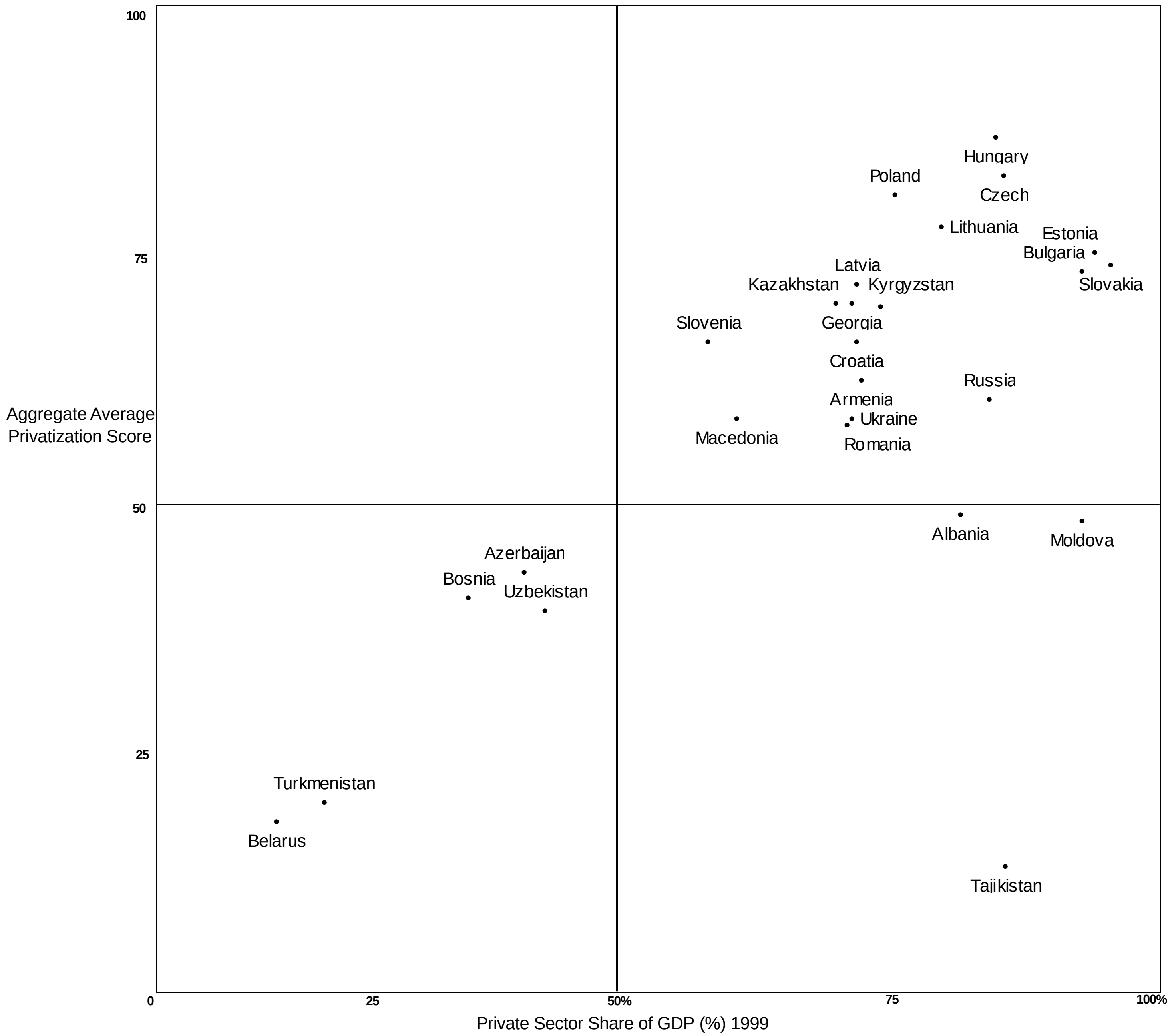
Most of the countries in Central Europe and the former Soviet Union have made significant progress towards privatization, especially when viewed in aggregate. Figure 5 is an attempt to graphically indicate the overall status of each country in terms of two sets of measures:

- The horizontal axis indicates the private sector share of GDP as estimated by the EBRD for 1999.
- The vertical axis provides an aggregate average privatization score based on the results of Figures 1-4.

The most striking result is that 19 of 26 countries are in the upper right hand quadrant, suggesting that the private sector represents more than 50% of GDP and that the countries averaged more than 50 points in privatizing the five types of enterprises/assets (small scale, medium/large enterprises, land/agriculture, utilities, and financial sector.

The close correlation between the percent private sector share in GDP and the privatization "score" is also notable. This correlation gives greater credibility to both measures since intuitively, the private sector role in the economy should be a reflection of the extent of privatization, and vice versa.

FIGURE 5: Overall Status of Privatization & Private Sector Role



Source: *Private sector share of GDP from EBRD, Transition Report 2000*

Estimate of privatization derived from prior tables. Sum of score on small scale, agriculture/land titling, electricity/telecommunications & financial/private assets divided by 5.

The figure suggests that the initial drive, following the collapse of the Berlin Wall and then of the Soviet Union, of creating economies dominated by private enterprise, has largely succeeded. What remains to be done involves country and sector specific issues, deepening market forces/competition and “laggards”. More specifically these remaining tasks are summarized by sector/type of asset in Figure 6 below.

The theme that emerges is that remaining privatization tasks will need to be approached on a country and sector specific basis. In countries that have progressed the furthest, continued privatization efforts should be viewed strategically. For example, for which initiatives is the political “cost” (and financial cost to donors) more than justified by the resulting impact on the economy, the functioning of markets and the level of competition? In which cases are there diminishing returns from continued privatization efforts where the costs and effort required exceed the likely benefits? The conclusion of this paper is that for most countries, across the board privatization programs are no longer justified. Remaining initiatives need to be carefully targeted.

Figure 6
Remaining Privatization Tasks and Their Implications

Sector	Remaining Tasks	Implications
Manufacturing/ Mining	• Sale of residual shares (especially for most mass privatization countries) • Sale of selected strategic companies (in most countries) • Sale of unattractive assets (offered for sale but no buyers at an "attractive price" • Comprehensive sale of assets still required in specific countries: Bosnia, Serbia, Kosovo	• Implement auction methods for residual shares; strengthen corporate governance • Can be sold "commercially" in most cases • Liquidation procedures needed; or simply let them wither away. • Implement systematic sales programs based on lessons from past experience
Agriculture/ Land	• Restructuring of collective farms (especially FSU) that are nominally privatized • Systematic land titling, strengthening of land markets	• Need systemic/integrated approach to agriculture and agribusiness • Development of functioning land market only just beginning
Utilities/ Transport	• Restructuring/privatization/regulation of electricity, telecom, railroads, etc.	• Liberalization/competition/privatization strategies need to be customized for each country
Financial Sector	• Privatization of state owned banks and insurance companies • Clean up of troubled portfolios	• Sector specific strategies for relevant countries
Municipal Services	• Water, sewage, municipal transport, social Services barely addressed	• When and how is privatization an option for improving management and service? • Few models exist for "rolling-out" programs to large numbers of local governments

B. USAID & Other Donor Involvement

USAID has provided the principal impetus among donors in pushing for and facilitating broad and deep privatization in the transition economies. The World Bank and to a lesser extent the IFC, EBRD and other bilateral donors have also been players. The focus of USAID support has been, to a large extent, SO1—the transfer of assets into the private sector.

In the initial stages of transition, donor support for privatization had a primarily political agenda, in which the objective was to rapidly transfer assets into private hands. Privatization (sale of assets) was seen as an end in itself—in order to make the demise of the centrally planned economy irreversible, break the power base of the former system, and introduce private ownership as the foundation of a new economic and political order. Although this political objective has largely been accomplished (as seen in Figure 5), concerns emerged that privatized firms were not restructuring or performing as expected, and that lack of transparency and corporate governance were impeding the transition process.

These concerns led to a second phase of support. Under this phase, donors focused less narrowly on the transfer of assets, and more broadly on the development of the institutional framework, including commercial law, accounting standards, bankruptcy and liquidation procedures, capital markets, etc, that would provide an environment supportive to private sector growth. Research suggests that the impact of privatization is greater when accompanied by the parallel development of the institutional, legal and regulatory framework, including mechanisms for the recognition and enforcement of contracts (including land titles), protecting minority shareholders, implementing bankruptcy and liquidation, facilitating financial intermediation, etc.[6]

Donor support is currently moving into a third phase, under which increased focus is being placed on economic efficiency. This support has been particularly evident in specific sectors, such as utilities, as well as selected initiatives, where emphasis has been placed on promoting competition (and not just private ownership).

The principal types of support for privatization are categorized and briefly described below.

1. Support for sales process (transfer of assets)

The principal feature of USAID support for privatization has been to help the central privatization authority (State Property Fund, Privatization Ministry, etc.) to structure and

[6] See Jeffrey Sachs, Clifford Zinnes and Yair Eilat, "The Gains from Privatization Economies: Is "Change Ownership" Enough", HIID, 2000; John Nellis, "Privatization in Transition Economies: What Next?", mimeo, August 2000; and Simeon Djankov and Peter Murrell, "The Determinants of Enterprise Restructuring in Transition: An Assessment of the Evidence," unpublished draft, May 2000.

implement one or more methods for systematic privatization. Assistance has been provided through:

- Intensive, hands-on support for organizing and implementing cash auctions, vouchers, tenders, land titling. Mostly for manufacturing and distribution, and in a few cases land. Examples include Russia, Kazakhstan, Kyrgyzstan, Moldova, Ukraine, Romania, Bosnia, and Montenegro.
- Advisory support providing recommendations, with less involvement in implementation. Examples include Poland and Hungary.
- Responsibility for specific transactions (acting as an investment bank). Examples include pharmaceutical companies in Bulgaria, energy companies in Moldova.

Some lessons learned include:

- USAID has generally developed successful models for systematically supporting the rapid privatization/transfer of assets.
- Where the number of transactions has been low, the main obstacle has been a lack of political will.
- In situations where advisors work as investment bankers," or intermediary brokers, the question arises as to whether USAID (or other donors) should be subsidizing these transactions or whether they can be managed commercially.
- Reasonable valuation is always a problem, and it underscores the difficulty of selling unattractive/distressed assets (most of what is being offered).
- Transfer of assets in the absence of a supporting "institutional framework" with laws on, and implementation of, bankruptcy, contract enforcement, corporate governance, accounting reform, etc. does not necessarily lead to greater economic efficiency.[7] Growing concern over the poor performance of privatized companies has led to a change in emphasis on the part of USAID from the transfer of assets to the development of the supporting institutional framework.
- USAID has experienced less success with broad privatization of agriculture/farms, with the exception of Moldova and Georgia, and to a lesser extent Ukraine. However, this has not been a major focus until recently.

2. Competition & regulation

USAID support for demonopolization, competition, and regulation has been of primary importance in sectors other than manufacturing. Early on, USAID supported projects that looked at breaking up monopolies in distribution systems such as those that existed in Kazakstan, Moldova, and Kyrgyzstan. There has also been some support for anti-monopoly and competition enforcement agencies. More recently, USAID has been addressing competition and regulation in the electricity/energy and telecommunications sectors. USAID is also supporting some competition projects in banking, but these are primarily aimed at banking supervision.

[7] See, for example, "Privatization in Transition Economies: What Next?" by John Nellis (7/2000); "Time to Rethink Privatization in Transition Economies?" by John Nellis, (IFC Discussion Paper #38); "The Gains from Privatization in Transition Economies: Is "Change of Ownership" Enough?" by Jeffrey Sachs, Clifford Zinnes, Yair Eilat, (HIID, CAER II Discussion Paper 63, 2/2000).

3. Post privatization, corporate governance and capital markets

As it became clear that the transfer of assets was not leading to the expected restructuring and improved performance of firms, USAID has looked at ways to deepen the impact of privatization through:

- *Post privatization projects:* Initial efforts focused on restructuring individual companies. However, the cost per company was too high relative to the results and the number of companies requiring assistance. In reaction, USAID then focused projects more on building capacity (local consultants, business service providers), tool kits, and financial intermediaries able to provide financing and support, and moved away from the intensive support for individual SMEs. Until recently, projects to support privatized and new SMEs with business services (marketing, financial management, etc.) have generally been kept separate from privatization projects. In a few cases post-privatization support is channeled through investment funds on the assumption that they have a vested interest in restructuring companies in which they hold shares (e.g. Ukraine).
- *Capital markets projects:* These projects have been developed to facilitate secondary trading of shares (following mass privatization), and as a mechanism for companies to raise capital. To date, stock exchanges and the broker dealer networks in the region have been relatively underutilized for secondary trading, primary issues and underwriting, and as platform for further privatization, especially of residual shares. The sale of small share packages in blue chip companies, such as telecoms, could give citizens access to valuable equity.
- *Bankruptcy support:* The aim of these projects has been to strengthen the judicial process and capacity for bankruptcy, restructuring and/or liquidation of companies.
- *Accounting reform:* The aim of these projects has been to strengthen transparency and financial accountability in both the private and public sectors.
- *Commercial law:* The aim of these projects has been to establish and strengthen property rights, contracts, etc., as an essential component of an enabling environment for private sector growth.

III. Drivers Shaping the Privatization Process

This section highlights some of the key driving forces (drivers) shaping the privatization process, and outlines their implications for the future direction of privatization. The table below outlines drivers by principal stakeholder and indicates the principal expectations or objectives expected from privatization by each group. In the final column, the table outlines the implications for the future direction of privatization.

Objectives for Privatization and External Pressures, by Stakeholder

Stakeholder	Objectives	Drivers	Stakeholder Implications
Government	• Revenues • New investment/technology • Preservation of jobs • International approval	• Political backlash • Entrance requirements to EU/WTO • Donor conditionalities • Corruption • Competition/competitiveness vs. high asset prices	• More strategic approach to privatization focused on key obstacles to competitiveness and economic growth
USAID and Other Donors	• Achieve private sector based economy: Transfer assets • Economic efficiency/growth • Institutional development • Transparency	• Privatization fatigue • Congressional/stakeholder concern with results	• Declare victory on overall transfer of assets • Target bottlenecks to economic efficiency/ growth • Need for new models with regional application • How to measure results?
Potential Investors	• ROI • Access to markets	• Political risks and contingent liabilities • Option of investment in Greenfield opportunities or other countries	• Increasingly careful about buying state assets
Privatization Agencies/ Line Ministries/ Enterprise Managers	• Maintain control; director stipends; revenues • Restructuring	• Reform vs. inertia/status quo	• Slow down privatization or find ways to retain control
General Population	• Better choice/quality/service • Jobs/income	• More information on choices	• Need to perceive the benefits of privatization
Shareholders: Highly Connected Officials and Citizens with Majority Stakes	• Dividends or capital gains • Control company management	• Political backlash against "oligarchy"	• How many will move beyond strategy of stripping assets or "muddling" along?
Shareholders: Average Citizen with Minority Stake	• Dividends or capital gains • Good corporate governance	• Disillusionment with "share" ownership	• What to do with shares and savings?

To expand upon some of the points raised in the preceding table, the future direction of privatization is likely to be particularly affected by the following drivers:

- **Concern over political backlash.**

Political backlash arises from the perception that privatization has failed. Privatization was initially "sold" by governments and donors on the basis that private ownership would lead to improved management and new investment, as well as valuable shares for citizens that had received vouchers. The general perception, however, is that not enough companies have restructured or prospered while shares in many privatized companies are virtually worthless. This has generated greater resistance to privatization, or at least to rapid and mass privatization, even among the donor organizations. To the extent that privatization is supported, governments (and donors) need a strong economic rationale (articulated in number of jobs, growth, and competitiveness). The resulting emphasis is increasingly on strategic buyers that can better provide the needed investment and restructuring, as well as systemic, sectoral strategies that provide clear benefits to consumers and other interest groups (e.g. better and cheaper telecommunications; better access to market for farm output).

The available empirical evidence does not support the conclusion that privatization failed. What is evident is that unrealistic expectations were created regarding what could be achieved, especially in the manufacturing sector, by privatizing highly over-dimensioned, poorly located, obsolete, and value subtracting factories. Indeed, for many of the remaining unattractive assets it is difficult to make a compelling economic case on the benefits of privatization. The very valid question therefore arises as to whether it is politically and economically worth pushing for the sale of the entire universe of state companies.

- **Focus on competition and competitiveness.**

Focus is moving from change of ownership to competition/markets, which in turn changes the focus from the success of individual firms to the competitiveness and dynamics of sectors. The change in focus primarily reflects the greater emphasis on privatization, especially by donors, on sectors other than manufacturing/production. Interest in utilities, the financial sector, social and municipal services requires thinking beyond just transfer of ownership. There is a need to think of the impact on the entire economy of what happens to the sector, based on the privatization strategy adopted. If a privatized manufacturing company fails, the consequence is mostly loss of jobs; if privatization of an electricity monopoly is poorly handled, results can include much higher costs of electricity, insufficient supply, and loss of economic competitiveness. This line of reasoning results in more "systemic" and strategic thinking about privatization, and requires a clear and compelling economic rationale.

- **Interest in strategic investors.**

The search for deeper restructuring and new investment in companies leads to increased enthusiasm for one dominant (strategic) investor over broad citizen ownership. Enthusiasm for "mass privatization" programs as the primary means of privatization has largely disappeared, replaced by the desire for strategic investors that purchase a controlling block of shares. Tenders and direct sales have become the preferred means of selling majority shares in companies that are not yet privatized.

For countries that have implemented mass privatization programs, concentration of ownership could theoretically be achieved through purchase of private and/or state residual shares on the stock exchange. However, emerging stock markets are rarely serving as the basis for investors to take over corporate control (in a transparent fashion). At the same time, few countries have capitalized on the opportunity to sell residual shares through auctions, broker dealers, and/or exchanges.

- **Aspiration to EU membership.**

In countries that aspire to EU membership, privatization will be shaped by rules on competition and government subsidies to state-owned companies. In general, this implies that governments will have to allow new entries into most sectors, and limit subsidies to large government owned and loss making companies, such as airlines, and others considered to be strategic assets.

- **Investor preference for "greenfields."**

Many international and local investors prefer greenfield investments. Investors have figured out that it is often cheaper and easier to start from scratch, hire, and train their own labor force, rather than acquire existing assets. This approach limits the number of companies that can be sold to strategic investors and/or the price they can be sold for. Investors also seek low prices given the need to invest in the purchased company (sales proceeds usually go to the government, not to the enterprise) as well as environmental and other liabilities. With limited numbers of investors interested in state assets (especially when governments seek high prices), the question is how to dispose of unattractive assets.

IV. Reformulating USAID's Privatization Strategy

The phase in the transition process during which privatization is perceived as an end in itself (as reflected in E&E's SO 1.1) is largely complete and successful. With the exception of a few countries (such as Serbia, Belarus, Turkmenistan and Bosnia), the political agenda of breaking down the old command and control system has been achieved. A significant percentage of productive assets are, at least nominally, in private hands. The institutional framework required to support private enterprise is beginning to emerge. So the question is now being posed as to whether there is a future role for privatization as a discrete task in the transition process.

The principal conclusion of this exercise is that the focus of privatization needs to change. *Privatization must be seen as part of the means to an end, in particular economic efficiency, rather than as an end in and of itself*. In this regard, the focus of privatization moves from the transfer of assets into private hands (current SO 1.1) to the following:

- *Transferability of property rights (shares, land, other assets), effective corporate governance, contract enforcement, adequate financial reporting, and minimum barriers to market entry and exit.* Private citizens must have the incentives and tools to look after managing their assets and maximizing returns.

- *Focus on fair markets, enforcement of competition rules and demonopolization.* As countries seek to join the EU, the WTO, and the global economy, competition and functioning markets become the foremost goals.

This approach to privatization (as a means to an end) fits within E&E's Strategic Framework for 2000 and Beyond, where Strategic Assistance Area I: Economic Restructuring has the following goal: "Foster the emergence of a competitive, market-oriented economy in which the majority of economic resources is privately owned and managed." E&E has thus defined privatization as one component that will contribute to encouraging competition and competitiveness. Approaching SO 1.1 in this context will assist in focusing privatization initiatives strategically.

In this context, privatization becomes an element of broader, cross-cutting transition projects/programs aimed at breaking through key bottlenecks to competition and transferability of assets. Principal examples of how privatization fits into other USAID initiatives include:

- Liberalizing strategic infrastructure sectors, such as energy, telecommunications, water and sewage, transportation services, etc., to encourage new entrants, investment, technological innovation and competition. Segmentation and sale of existing companies may or may not be implemented, but must be considered as an option.
- Systematic land titling and privatization programs that provide owners with clear title and the ability to buy and sell, as well as use land as collateral.
- Financial sector reform aimed at facilitating financial intermediation, and the emergence of a range of financial service providers that reliably meet the needs of savers and users of capital.
- Improving the delivery of municipal services required by enterprises and the population (water, sewage, education, transport, etc.). In this case, privatization may take the form of management contracts and/or concessions. Again, it will be only one aspect of a strategic approach that includes restructuring, demonopolization, liberalization, and regulation.
- De-bottlenecking agribusiness/agriculture "value chain" linking farmers with processors and markets in which state held or controlled entities limit the emergence and development of market based systems.
- Making it easier for private owners to restructure enterprises, especially in cases where the state maintains a significant or "golden" share, by supporting the systematic privatization of residual shares.
- Supporting institutions and mechanisms that generate the information needed for successful markets, and the tools required by owners to exercise their rights (contract enforcement, corporate governance, accounting reform, etc.)

For all of these initiatives, “best practice” models can be developed that are applicable on a regional basis. All can be incorporated into strategic programs that continue the development of market economies and facilitate full integration into the global economy. But except for the “laggard” countries, the phase of broad, general “privatization” projects is over.